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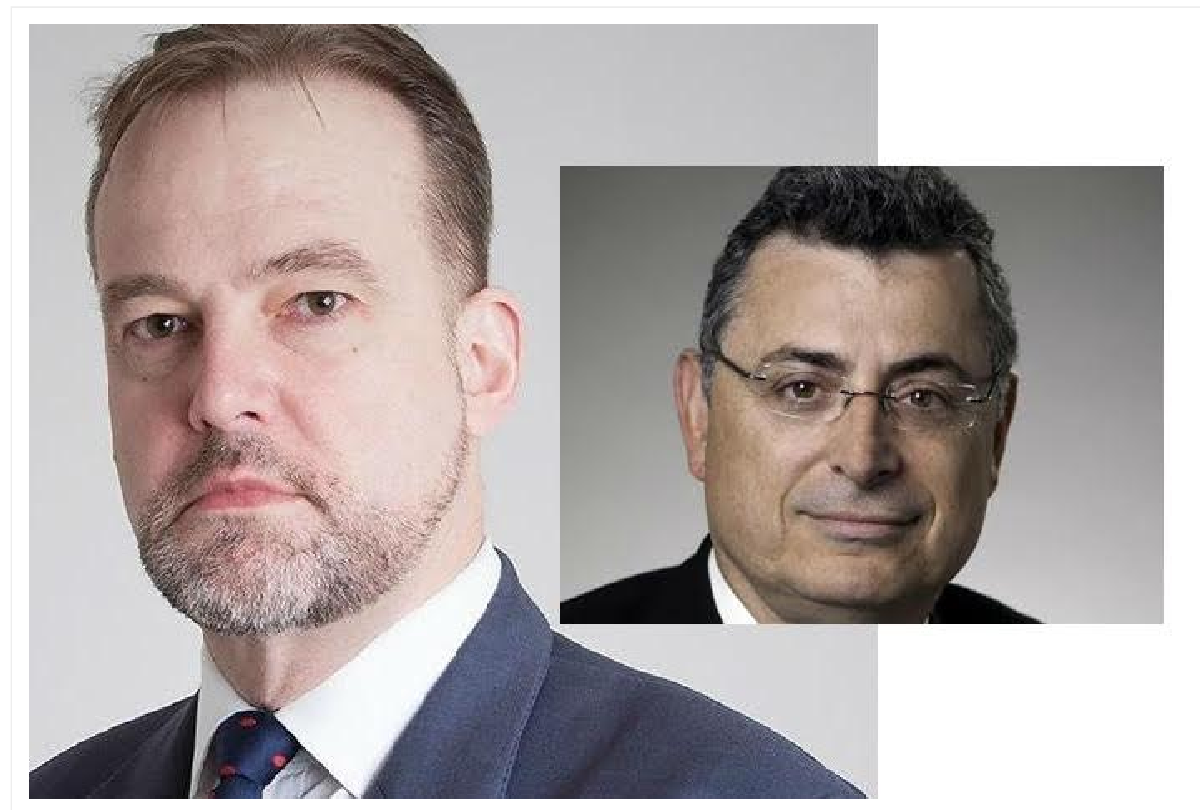
Who's driving the liquidity event?



By Oded Ben-Joseph & Shawn Manning

03-05-2017 Comments (0)

In a hard-hitting expert view piece, Dr Oded Ben-Joseph and Dr Shawn Manning, from investment bank Outcome Capital, advise on how life science companies can achieve shareholder objectives without falling into some common traps.

The principal purpose of all commercial ventures is to deliver shareholder return. Among listed companies, this is typically manifested by an increase in equity value, driven by positive news flow, value accretive transactions (particularly acquisitions at a share price premium) or dividend payments. While listed life science companies conform to this established model, for private mid-market life science companies with an investor base typically consisting of private equity, venture capital, corporate venture and management, a liquidity event in the form of an initial public offering (IPO) or value accretive acquisition is the most common route to shareholder return.

Timely achievement of a liquidity event should therefore represent the key objective of all small to mid-market life science companies. Commercial progress, in the form of data generation supporting product progression through to market, and auxiliary events that lend support to this process (ie collaborations, changes in the competitive environment and regulatory progression and/or acceleration) are the key drivers towards achieving these outcomes.

As advisers and transaction professionals in the life sciences sector, one of our key questions when engaging with new clients is 'who' is driving the company towards a positive liquidity event?

Harnessing personal and company goals

In the ideal scenario, investors, management and employees, are all aligned as shareholders seeking optimal capital efficiency and return on investment. Sadly, however, this ideal situation tends to be the exception rather than the rule.

Very often management and employees are motivated by factors other than return on investment. Employees may view their role principally as an opportunity to pursue research interests or career progression as a 'stepping stone' to greater things.

While these are no bad things per se, and often understandable in the case of junior hires, management's responsibilities encompass harnessing these personal goals as closely as possible alongside those of the company, often incentivizing employees with an equity stake.

More worrying, but surprisingly common, are incidences where senior management, which should be a key beneficiary of a successful liquidity event, is motivated by other factors. C-level management, particularly those that have exited a career in a larger life science multinational (or even those that have successfully 'cashed in' after having played a role in executing a liquidity event in another small company), may view their role as essentially a 'retirement job', and as such lack incentive to drive value.

At best, this may manifest itself as ambivalence regarding the timeliness of converting equity to cash, and at worse, a contentedness to take a healthy compensation package and senior job title role in lieu of propelling growth in equity value.

'Fear of failure'

We believe this 'lifestyle' approach is generally more common in Europe than the USA, likely resulting from lower levels of industry visibility, a relative lack of expert scrutiny and insight from industry observers and investors, sometimes less rigorous corporate governance, a 'less hungry' approach by companies to delivering timely capital returns, and a culture that is less accepting of failure and 'lessons learnt'.

Such an approach is often, but strangely not always, coupled with an ignorance of shareholder's expectations pertaining to return on capital and risk. We recall (with abject horror) one European CEO who referred to investment as 'R&D donations'.

The situation may be exacerbated in situations where an executive's 'fear of failure', and associated concerns regarding future employment, may act as a barrier to company progress, particularly if shareholder value is dependent on a positive outcome associated with a risky 'binary' event.

In contrast, we note that more dynamic management is often keener to embrace risk, with the intention of either capitalizing on equity return or failing in as capital efficient manner as possible, learning valuable lessons, and moving onto the next and more likely successful venture.

This approach is exemplified in the US market, where even accounting for the relative abundance of life science career opportunities, we believe it has contributed to the historic overall success of the life sciences sector.

When problems arise with management incentivization, there is a clear disjoint with the potential for an insurmountable hurdle to be placed in the path of shareholder return. In other words, board and management are grossly misaligned.

In addition to disincentivizing further investment, in some cases investors themselves may be left 'holding the baby', with a requirement to take direct strategic and/or operational responsibility for generating a financial return.

The effective alignment of all parties, with respect to driving liquidity, should be a core element of corporate governance, pursued and enforced by the board on an ongoing basis.

Danger of 'the agency problem'

As a company evolves, management succession should be carefully overseen – while entrepreneurial scientists may be best positioned to develop an initial concept, it does not necessarily follow that they will be best positioned to attract further investment and deliver shareholder liquidity.

As such, the choice of effective C-level successors should ensure that individuals are effectively selected, suitably remunerated (ie, with a weighting towards equity versus cash) and carefully briefed (in terms of expected timescales for deliverables) with respect to their role.

This process requires both diligence, tenacity and objectivity on the part of the board – if it does not count proactive investors among its numbers, the risk is run that the role falls instead to other less commercial non-executives, often blind to the value and drivers of liquidity.

In conclusion, we often see companies facing what is referred to in the field of behavioral finance as 'the agency problem', whereby a person or entity (the 'agent'- typically a C-level executive) is able to make impactful decisions on behalf of another person or entity (the 'principal'/shareholders) which is not necessarily in the best interests of the latter.

While the agents act in their own best interests, decision-making and execution is sub-optimal in terms of delivering shareholder value. It is thus imperative that board members are mindful that their invested company, particularly one that is not subject to constant third-party scrutiny (ie by the capital markets), may be at risk of turning into a 'lifestyle' entity, geared more towards the personal objectives of management.

As such, the board should do its best to ensure that their management team remain focused on achieving the principal shareholder objective – driving the liquidity event.

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